SENATE TAXATION
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# Revenue Impacts of SB 407

## Executive Summary


The 2003 legislature passed SB 407. This bill reduced income tax rates, capped the itemized deduction for federal taxes, and provided a credit equal to 2% of capital gains income. It also imposed new taxes on lodging and rental cars and increased taxes on cigarettes and tobacco products.

The fiscal note for SB 407 estimated that the net reduction in general fund revenue for FY 2008 would be about $17 million. The actual net revenue reduction for FY 2009 was $43.9 million.

Revenue from the new taxes and excise tax increases in SB 407 is about what was predicted in 2003. The reduction in income tax revenue is much larger than predicted, largely because

Income is higher than was predicted,
Capital gains income is higher than was predicted,
Income growth after 2003 went disproportionately to higher income taxpayers, who received the largest percentage tax cuts from SB 407, and
The cap on the deduction for federal income tax limited the revenue windfall the state received from federal tax cuts.

High and low income taxpayers received the highest percentage reductions in income tax liability. The average reduction was less than 2% for taxpayers with incomes between $30,000 and $80,000. It was more than 10% for taxpayers with incomes less than $20,000 or more than $200,000.

More than half the reduction in income taxes went to taxpayers with income over $500,000.

## Introduction and Summary

The 2003 Legislature passed SB 407, which reduced income tax rates, capped the itemized deduction for federal taxes at $5,000 ($10,000 for a joint return), and provided a credit for a percentage of capital gains income (1% in 2005 and 2006 and 2% beginning in 2007). SB 407 also raised taxes on cigarettes and other tobacco products and imposed new taxes on lodging and rental cars.

In 2006, the Department of Revenue analyzed the impacts of SB 407. This paper updates and expands that analysis using information from 2008 income tax returns.

The first section explains the changes that SB 407 made to the individual income tax and other taxes.

The second section presents estimates of the reductions in 2008 income tax liability for full year resident taxpayers, both in total and by income group. For each group, it also shows the percentage change in tax liability and the change in average effective tax rate.

The third section presents estimates of the number and percentage of winners and losers in each income group, where winners and losers are defined in terms of having 2% lower or 2% higher income tax liability.

The final section looks at the net revenue impact of SB 407. It gives estimates of the reduction in income tax revenue and the revenue from the increases in lodging, rental car, cigarette, and tobacco taxes. It looks at reasons why the net revenue reduction has been larger than was predicted in 2003 and looks at how the impact of SB 407 may change in the next several years.

## SB 407

SB 407 reduced income tax rates, imposed two new selective sales taxes, and increased taxes on cigarettes and other tobacco products. During the 2003 session, it was estimated that the net effect on state revenue would be close to zero in FY 2006 but that there would be increasing revenue losses in later fiscal years.

SB 407 reduced the number of income tax rates, lowered the top and bottom rates, and made rate brackets much narrower. It also capped the itemized deduction for federal income taxes at $5,000 ($10,000 for a married couple filing a joint return), and created a new non-refundable credit equal to 2% of a taxpayer's capital gains income. This new credit is equivalent to taxing capital gains at a lower rate than ordinary income.

Table 1 shows the income tax changes in SB 407.

**Table 1**
**Income Tax Provisions of SB 407**

Income Tax Rates
Brackets Adjusted for Inflation to 2008

Old Law

| Taxable Income | Marginal Tax Rate |
|---|---|
| $0 to $2,700 | 2.0% |
| $2,701 to $5,300 | 3.0% |
| $5,301 to $10,600 | 4.0% |
| $10,601 to $15,900 | 5.0% |
| $15,901 to $21,200 | 6.0% |
| $21,201 to $26,500 | 7.0% |
| $26,501 to $37,100 | 8.0% |
| $37,101 to $53,100 | 9.0% |
| $53,101 to $92,900 | 10.0% |
| Over $92,900 | 11.0% |

SB 407

| Taxable Income | Marginal Tax Rate |
|---|---|
| $0 to $2,600 | 1.0% |
| $2,601 to $4,600 | 2.0% |
| $4,601 to $7,000 | 3.0% |
| $7,001 to $9,500 | 4.0% |
| $9,501 to $12,200 | 5.0% |
| $12,201 to $15,600 | 6.0% |
| Over $15,600 | 6.9% |

Deduction for Federal Income Taxes

| Old Law | SB 407 |
|---|---|
| Itemized deduction allowed for full amount of federal income tax paid during year. | Deduction limited to $5,000 ($10,000 for joint return). |

Taxation of Capital Gains Income

| Old Law | SB 407 |
|---|---|
| Same as ordinary income. | Credit equal to 2% of capital gains income. |

Table 2 shows the new taxes and the increases in cigarette and tobacco taxes.

**Table 2**
**Other Tax Provisions of SB 407**

| | |
|---|---|
| Accommodations | New 3% sales tax |
| Rental Cars | New 4% sales tax |
| Cigarettes | Increased tax rate by $0.52 per pack |
| Other Tobacco Products | Increased tax rate from 12.5% to 25% (rate for moist snuff expressed in cents/ounce) |

These new taxes and tax increases were imposed beginning in 2003, while the income tax changes went into effect in 2005, with the capital gains credit going from 1% to 2% in 2007. SB 407 was expected to result in net revenue increases in FY 2003 through FY 2005, be close to revenue neutral in FY 2006, and to result in net revenue decreases in later fiscal years.

## Income Tax Revenue Reduction

Tax liability for 2008 was calculated for all timely-filed full year resident returns under current law and under the law as it existed before SB 407. Table 3, on the next page, shows the total change in tax liability and the change for thirty-five income groups. The left side of the table shows the range of income for each group, the number of households in the group, and the total income of these households. In this context, a household is defined as a married couple, filing either a joint return or separate returns on the same form, or an individual filing as single, head-of-household, or married with the spouse either filing on a separate form or not filing a return. Total household income is the sum of total income reported on the taxpayer's federal return and state additions to federal income. The right side of the table shows total tax liability of households in each group under pre-SB 407 law and under current law and the difference.

Table 4, on the following page, shows the changes in tax liability in the right-hand column of Table 3 as a percent of pre-SB 407 tax liability and as the average change per household. It also shows the average effective tax rate, which is tax liability divided by total household income, under the old law and under current law.

## Table 3
## Impact of SB 407 on Full-Year Resident's 2008 Income Tax

| Income Brackets | | | Tax Liability of Households in Bracket | | |
|---|---|---|---|---|---|
| Income Range | Number of Households in Bracket | Total Income of Households in Bracket | Old Law | SB 407 | Difference Due to SB 407 |
| $ 0 - $ 1,999 | 14,398 | $14,188,170 | $1,350 | $568 | -$782 |
| $ 2,000 - $ 3,999 | 16,895 | 51,055,669 | 128,540 | 63,118 | -65,422 |
| $ 4,000 - $ 5,999 | 17,661 | 88,147,148 | 462,625 | 239,991 | -222,633 |
| $ 6,000 - $ 7,999 | 16,794 | 117,280,013 | 870,358 | 507,505 | -362,854 |
| $ 8,000 - $ 9,999 | 16,059 | 144,576,885 | 1,306,423 | 841,857 | -464,566 |
| $ 10,000 - $ 11,999 | 15,554 | 170,937,665 | 1,693,420 | 1,169,297 | -524,122 |
| $ 12,000 - $ 13,999 | 15,273 | 198,426,889 | 2,195,964 | 1,629,510 | -566,454 |
| $ 14,000 - $ 15,999 | 14,706 | 220,531,089 | 2,759,927 | 2,170,382 | -589,545 |
| $ 16,000 - $ 17,999 | 14,483 | 246,138,801 | 3,392,557 | 2,813,535 | -579,021 |
| $ 18,000 - $ 19,999 | 14,083 | 267,441,258 | 4,043,593 | 3,517,560 | -526,033 |
| $ 20,000 - $ 24,999 | 32,019 | 717,573,586 | 12,555,431 | 11,661,593 | -893,839 |
| $ 25,000 - $ 29,999 | 27,247 | 747,589,458 | 14,990,597 | 14,634,714 | -355,884 |
| $ 30,000 - $ 34,999 | 23,197 | 752,200,482 | 17,099,356 | 16,910,410 | -188,946 |
| $ 35,000 - $ 39,999 | 20,269 | 759,034,226 | 18,492,156 | 18,315,272 | -176,885 |
| $ 40,000 - $ 44,999 | 17,862 | 758,148,246 | 19,373,501 | 19,231,036 | -142,464 |
| $ 45,000 - $ 49,999 | 16,143 | 765,941,603 | 20,656,203 | 20,632,595 | -23,608 |
| $ 50,000 - $ 54,999 | 14,721 | 772,451,949 | 21,540,018 | 21,509,026 | -30,992 |
| $ 55,000 - $ 59,999 | 13,736 | 789,165,831 | 22,955,846 | 22,874,354 | -81,492 |
| $ 60,000 - $ 64,999 | 12,340 | 770,829,411 | 22,906,790 | 22,771,111 | -135,679 |
| $ 65,000 - $ 69,999 | 11,314 | 763,080,532 | 23,580,031 | 23,294,272 | -285,758 |
| $ 70,000 - $ 74,999 | 10,303 | 746,221,434 | 23,851,995 | 23,527,030 | -324,965 |
| $ 75,000 - $ 79,999 | 9,177 | 710,926,944 | 23,737,640 | 23,293,393 | -444,247 |
| $ 80,000 - $ 89,999 | 15,578 | 1,320,470,093 | 46,218,032 | 45,060,738 | -1,157,295 |
| $ 90,000 - $ 99,999 | 11,488 | 1,088,065,205 | 40,405,398 | 39,146,947 | -1,258,451 |
| $100,000 - $109,999 | 8,651 | 905,930,223 | 35,207,595 | 34,163,418 | -1,044,177 |
| $110,000 - $119,999 | 6,170 | 707,960,211 | 28,896,963 | 27,762,444 | -1,134,519 |
| $120,000 - $129,999 | 4,510 | 562,351,003 | 23,700,569 | 22,760,017 | -940,553 |
| $130,000 - $139,999 | 3,210 | 432,563,957 | 18,897,031 | 18,066,993 | -830,038 |
| $140,000 - $149,999 | 2,410 | 348,945,462 | 15,842,359 | 14,962,435 | -879,924 |
| $150,000 - $174,999 | 4,207 | 679,109,982 | 32,258,974 | 29,982,857 | -2,276,116 |
| $175,000 - $199,999 | 2,555 | 477,058,411 | 24,173,219 | 22,008,771 | -2,164,448 |
| $200,000 - $299,999 | 4,531 | 1,083,103,605 | 58,878,584 | 52,186,555 | -6,692,029 |
| $300,000 - $399,999 | 1,659 | 570,088,687 | 34,243,577 | 29,334,079 | -4,909,499 |
| $400,000 - $499,999 | 843 | 376,344,684 | 23,316,363 | 20,041,962 | -3,274,401 |
| $500,000 + | 1,829 | 2,439,137,383 | 168,670,538 | 129,559,207 | -39,111,332 |
| Totals | 431,875 | $21,563,016,195 | $809,303,523 | $736,644,551 | -$72,658,972 |

**Table 4**
**Impact of SB 407 on Full-Year Resident's 2008 Income Tax**

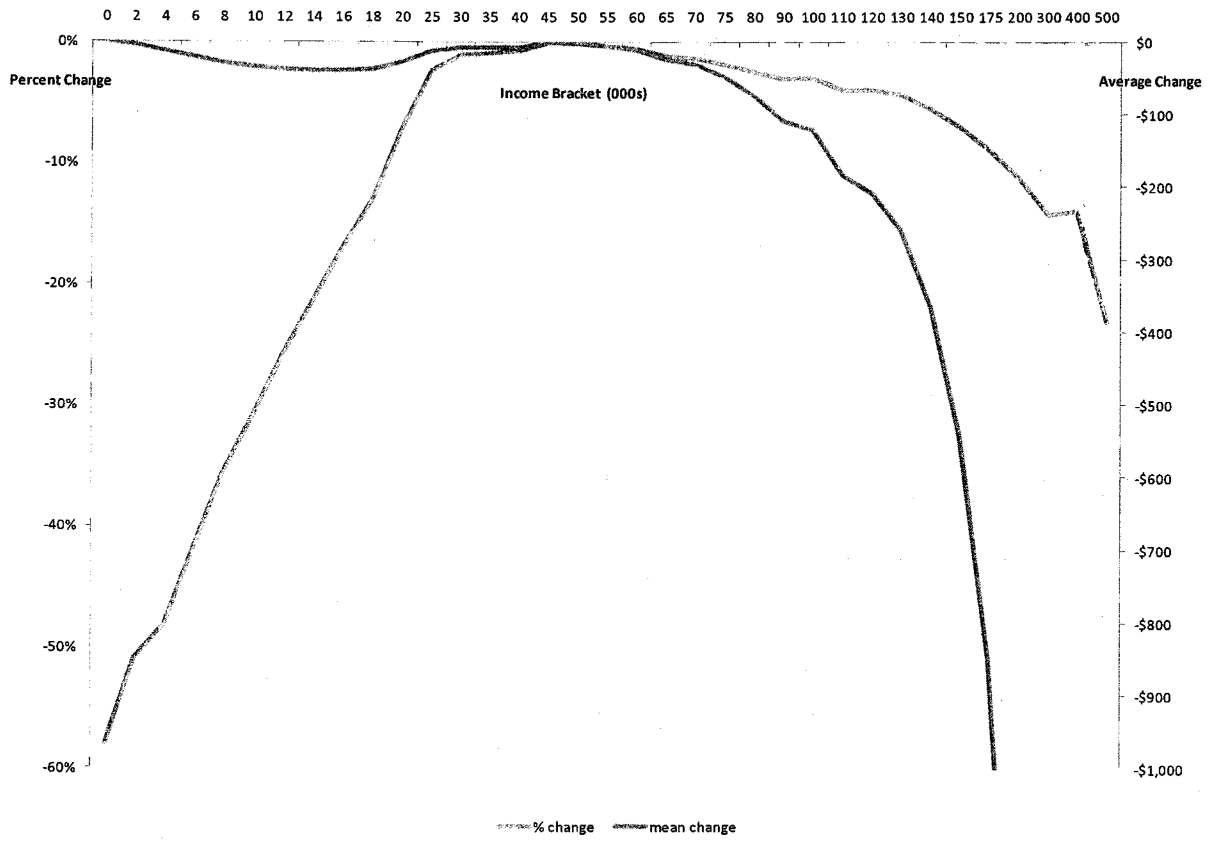
| Income Range | Change in Tax Liability: Percent Change | Change in Tax Liability: Average Change | Average Effective Tax Rate: Old Law | Average Effective Tax Rate: SB 407 |
|---|---|---|---|---|
| $ 0 - $ 1,999 | -58.0% | -$0.05 | 0.01% | 0.00% |
| $ 2,000 - $ 3,999 | -50.9% | -3.87 | 0.25% | 0.12% |
| $ 4,000 - $ 5,999 | -48.1% | -12.61 | 0.52% | 0.27% |
| $ 6,000 - $ 7,999 | -41.7% | -21.61 | 0.74% | 0.43% |
| $ 8,000 - $ 9,999 | -35.6% | -28.93 | 0.90% | 0.58% |
| $ 10,000 - $ 11,999 | -31.0% | -33.70 | 0.99% | 0.68% |
| $ 12,000 - $ 13,999 | -25.8% | -37.09 | 1.11% | 0.82% |
| $ 14,000 - $ 15,999 | -21.4% | -40.09 | 1.25% | 0.98% |
| $ 16,000 - $ 17,999 | -17.1% | -39.98 | 1.38% | 1.14% |
| $ 18,000 - $ 19,999 | -13.0% | -37.35 | 1.51% | 1.32% |
| $ 20,000 - $ 24,999 | -7.1% | -27.92 | 1.75% | 1.63% |
| $ 25,000 - $ 29,999 | -2.4% | -13.06 | 2.01% | 1.96% |
| $ 30,000 - $ 34,999 | -1.1% | -8.15 | 2.27% | 2.25% |
| $ 35,000 - $ 39,999 | -1.0% | -8.73 | 2.44% | 2.41% |
| $ 40,000 - $ 44,999 | -0.7% | -7.98 | 2.56% | 2.54% |
| $ 45,000 - $ 49,999 | -0.1% | -1.46 | 2.70% | 2.69% |
| $ 50,000 - $ 54,999 | -0.1% | -2.11 | 2.79% | 2.78% |
| $ 55,000 - $ 59,999 | -0.4% | -5.93 | 2.91% | 2.90% |
| $ 60,000 - $ 64,999 | -0.6% | -11.00 | 2.97% | 2.95% |
| $ 65,000 - $ 69,999 | -1.2% | -25.26 | 3.09% | 3.05% |
| $ 70,000 - $ 74,999 | -1.4% | -31.54 | 3.20% | 3.15% |
| $ 75,000 - $ 79,999 | -1.9% | -48.41 | 3.34% | 3.28% |
| $ 80,000 - $ 89,999 | -2.5% | -74.29 | 3.50% | 3.41% |
| $ 90,000 - $ 99,999 | -3.1% | -109.54 | 3.71% | 3.60% |
| $100,000 - $109,999 | -3.0% | -120.70 | 3.89% | 3.77% |
| $110,000 - $119,999 | -3.9% | -183.88 | 4.08% | 3.92% |
| $120,000 - $129,999 | -4.0% | -208.55 | 4.21% | 4.05% |
| $130,000 - $139,999 | -4.4% | -258.58 | 4.37% | 4.18% |
| $140,000 - $149,999 | -5.6% | -365.11 | 4.54% | 4.29% |
| $150,000 - $174,999 | -7.1% | -541.03 | 4.75% | 4.42% |
| $175,000 - $199,999 | -9.0% | -847.14 | 5.07% | 4.61% |
| $200,000 - $299,999 | -11.4% | -1,476.94 | 5.44% | 4.82% |
| $300,000 - $399,999 | -14.3% | -2,959.31 | 6.01% | 5.15% |
| $400,000 - $499,999 | -14.0% | -3,884.22 | 6.20% | 5.33% |
| $500,000 + | -23.2% | -21,384.00 | 6.92% | 5.31% |
| Totals | -9.0% | -$168.24 | 3.75% | 3.42% |

The percentage reduction in tax liability is smallest in the middle of the income distribution. It is 1% or less for households with income between $35,000 and $65,000. The percentage reduction is much higher for low- and high-income households. It is more than 10% for households with income less than $20,000 or more than $200,000.

The average reduction per household shows a more complicated pattern. It is lowest for the lowest income group, where most households have no tax liability under either old law or current law. The average reduction per household increases up to about $40 at $16,000 of household income and then decreases to about $1 at $45,000 to $50,000 of household income. It then rises steadily with income, to more than $21,000 for households with income over $500,000.

Figure 1 shows this information graphically. The blue line, plotted against the left-hand axis, shows the percentage change for each income group. The red line, plotted against the right-hand axis, shows the average dollar change for each group. The right-hand axis is truncated at $1,000 to show the variation at lower income levels.

**Figure 1**
**Changes in 2008 Average Tax Liability**
**Old Law to SB 407**



Average effective tax rates are lower for all income groups under SB 407 than under current law, but the differences follow a pattern that is similar to the pattern of percentage difference in tax liability. The difference is tiny, 1/100$^{th}$ of a percent, for the lowest income group, increases up to about $10,000 of income, and then decreases up to about $45,000 of income. Between $45,000 and $55,000 of income, the difference is 1/100$^{th}$ of a percent, and then increases with income, up to the highest income group, where the difference is 1.6 percentage points.

Figures 2 and 3 show average effective tax rates. Figure 2 shows average effective tax rates under old law and current law for all income groups. It shows that the difference in average effective tax rates is small up to about $150,000 of income and widens as income increases beyond that point. Under old law, the highest income group, with income over $500,000, had a significantly higher average effective tax rate than other taxpayers. Under current law, the group with income between $400,000 and $500,000 has the highest average effective tax rate, and the highest income group has a slightly lower average effective tax rate.

**Figure 2**
**Average Effective Tax Rates**

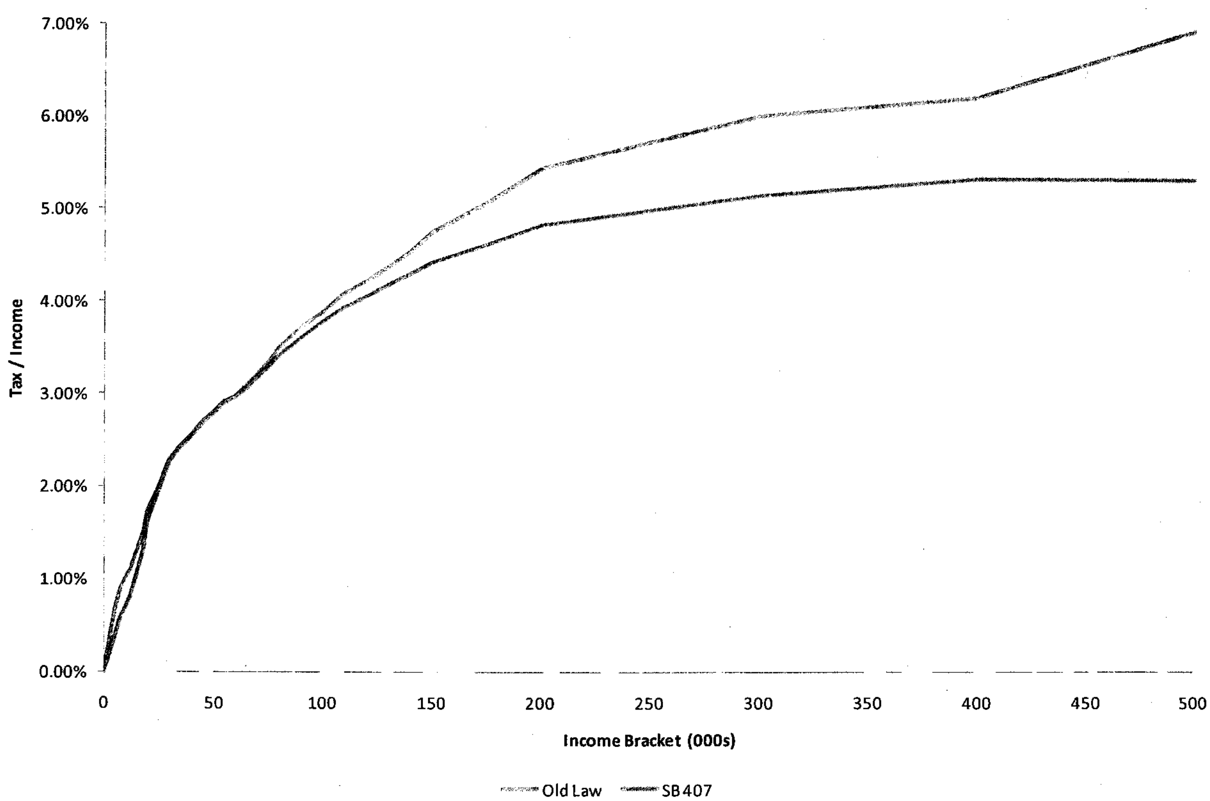
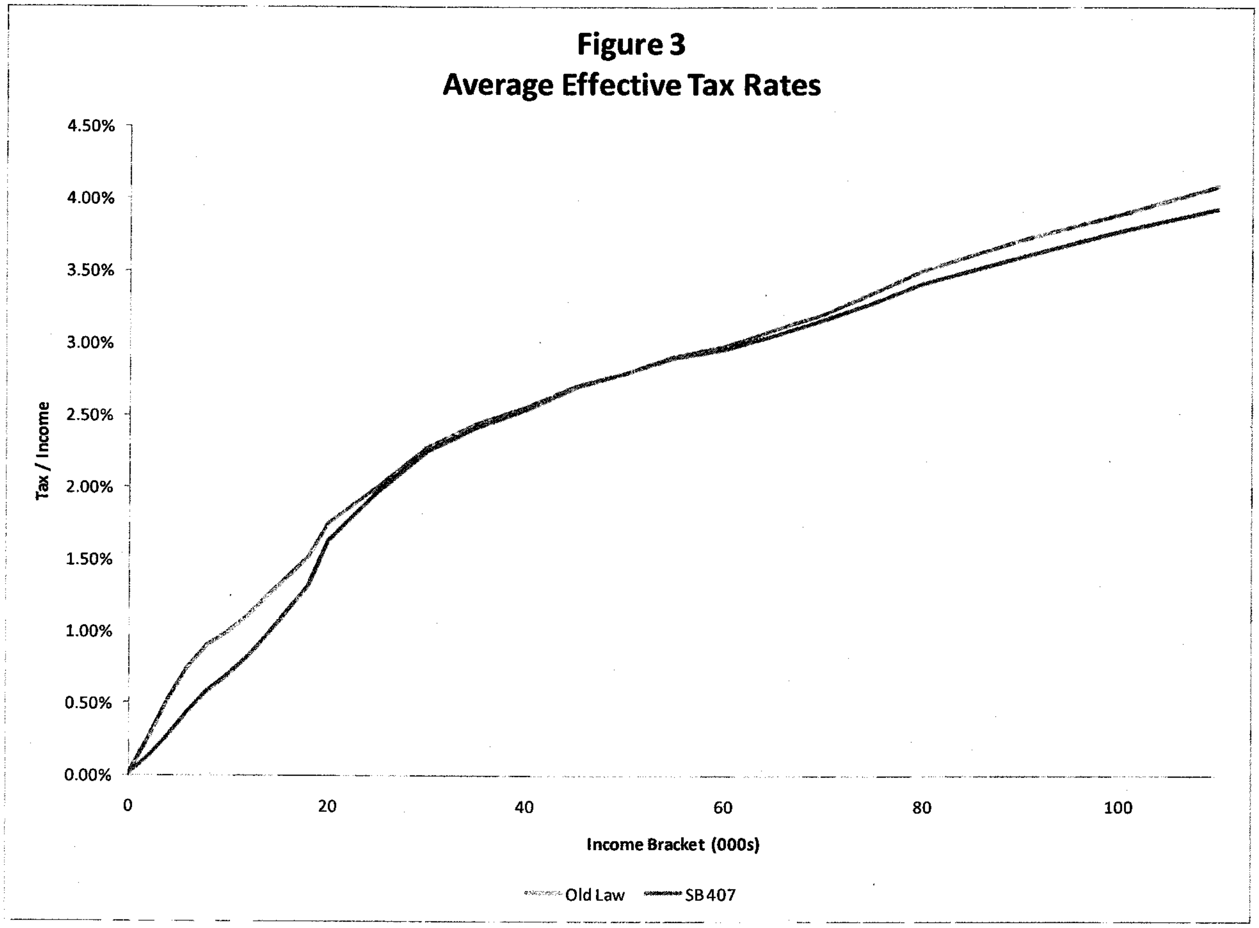



Figure 3 shows average effective tax rates for taxpayers with incomes of $110,000 or less. This includes 93% of households with 64% of total income. Figure 3 shows the very small difference in average effective tax rates for households with incomes between $30,000 and $65,000.




Tables 5 and 6 show some of the same information with households divided into only five income groups. The boundaries between groups are $20,000, $65,000, $150,000, and $500,000 of income.

The first three columns of Table 5 show the five income ranges and the number and percent of households in each group. The next two column show the income reported by each group and each group's percent of the total. The four right-hand columns show total tax liability for each group and each group's percent of total tax liability under pre-SB 407 law and under current law.

**Table 5**
**Impact of SB 407 on Full-Year Resident's 2008 Income Tax**

| | Households | | Income | | Old Law Tax | | Current Law Tax | |
|---|---|---|---|---|---|---|---|---|
| Income Range | Number | % | $ | % | $ | % | $ | % |
| $ 0 - $ 19,999 | 155,906 | 36.1% | $1,518,723,587 | 7.0% | $16,854,757 | 2.1% | $12,953,324 | 1.8% |
| $ 20,000 - $ 64,999 | 177,534 | 41.1% | $6,832,934,792 | 31.7% | $170,569,898 | 21.1% | $168,540,110 | 22.9% |
| $ 65,000 - $149,999 | 82,811 | 19.2% | $7,586,515,064 | 35.2% | $280,337,613 | 34.6% | $272,037,686 | 36.9% |
| $150,000 - $499,999 | 13,795 | 3.2% | $3,185,705,369 | 14.8% | $172,870,717 | 21.4% | $153,554,223 | 20.8% |
| $500,000 + | 1,829 | 0.4% | $2,439,137,383 | 11.3% | $168,670,538 | 20.8% | $129,559,207 | 17.6% |
| Totals | 431,875 | | $21,563,016,195 | | $809,303,523 | | $736,644,551 | |

The two highest income groups had 3.6% of households but 26.1% of income . While SB 407 reduced tax liability for all groups, the share of liability increased for each of the lower three income groups and decreased for both of the higher income groups. The top two groups' share of liability would have been 42.2% under the pre-SB 407 law but was actually 38.4%.

Table 6 repeats the information on number of households and old-law tax for each group and shows each group's tax reduction from SB 407. The third column from the right shows the total tax liability reduction for each group. The next column shows the percentage that reduction is of the group's old-law tax, and the right-hand column shows each group's share of the total reduction. For example, the middle income group had a total tax reduction of $8.3 million, which as 3.0% of their old-law tax liability and 11.4% of the total reduction for all taxpayers.

**Table 6**
**Impact of SB 407 on Full-Year Resident's 2008 Income Tax**

| | Households | | Old Law Tax | | Tax Reduction | | |
|---|---|---|---|---|---|---|---|
| Income Range | Number | % | $ | % | $ | Average % Reduction | % of Total Reduction |
| $ 0 - $ 19,999 | 155,906 | 36.1% | $16,854,757 | 2.1% | -$3,901,433 | -23.1% | 5.4% |
| $ 20,000 - $ 64,999 | 177,534 | 41.1% | $170,569,898 | 21.1% | -$2,029,787 | -1.2% | 2.8% |
| $ 65,000 - $149,999 | 82,811 | 19.2% | $280,337,613 | 34.6% | -$8,299,927 | -3.0% | 11.4% |
| $150,000 - $499,999 | 13,795 | 3.2% | $172,870,717 | 21.4% | -$19,316,493 | -11.2% | 26.6% |
| $500,000 + | 1,829 | 0.4% | $168,670,538 | 20.8% | -$39,111,332 | -23.2% | 53.8% |
| Totals | 431,875 | | $809,303,523 | | -$72,658,972 | -9.0% | |

The highest and lowest income groups had the largest percentage reductions, with both being over 23%. The groups with income between $20,000 and $150,000 had much smaller percentage reductions.

Each group's share of the total tax reduction reflects the combination of its share of old-law tax liability and its percentage reduction. The highest income group had about one-fifth of tax liability under old law, but because it had the highest percentage tax reduction, it received over half of the total reduction. The groups with income between $20,000 and $150,000 had over half of old-law tax liability, but because their percentage reductions were so small, they received about one-seventh of the total reduction.

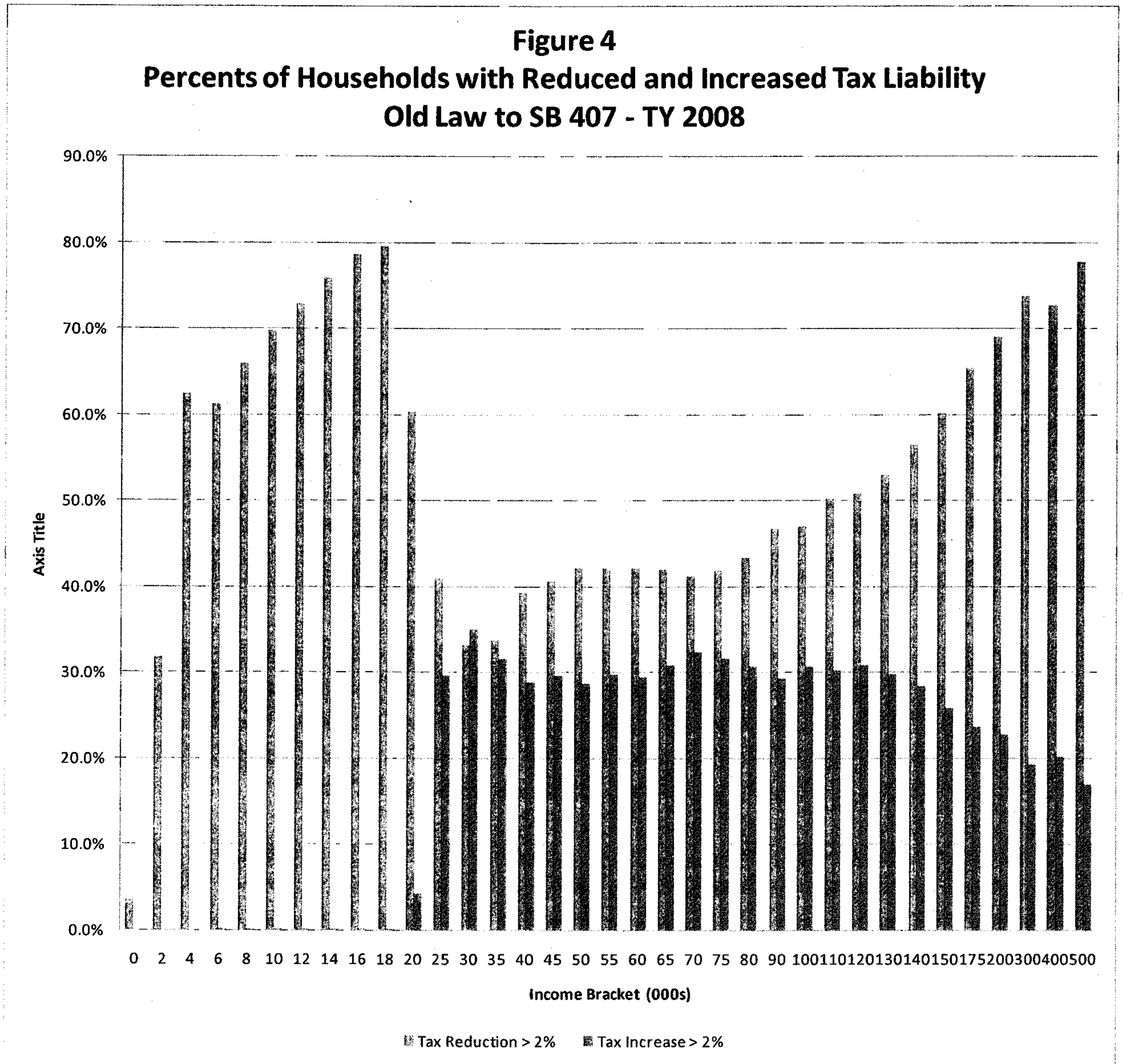
## Winners and Losers

Taxpayers with similar incomes were not necessarily affected the same by SB 407. Table 7 shows, for each of the 35 income groups, the number and percent of households with a tax reduction of more than 2%, with a tax increase of more than 2%, and with a change of less than 2%.

**Table 7**
**Taxpayers with Higher and Lower Taxes from SB 407**

| Income Brackets | | Tax Reduction > 2% | | Tax Increase > 2% | | Change < 2% | |
|---|---|---|---|---|---|---|---|
| Income Range | Number of Households in Bracket | Number of Households | % of Households in Bracket | Number of Households | % of Households in Bracket | Number of Households | % of Households in Bracket |
| $ 0 - $ 1,999 | 14,398 | 515 | 3.6% | 0 | 0.0% | 13,883 | 96.4% |
| $ 2,000 - $ 3,999 | 16,895 | 5,371 | 31.8% | 0 | 0.0% | 11,524 | 68.2% |
| $ 4,000 - $ 5,999 | 17,661 | 11,027 | 62.4% | 0 | 0.0% | 6,634 | 37.6% |
| $ 6,000 - $ 7,999 | 16,794 | 10,298 | 61.3% | 1 | 0.0% | 6,495 | 38.7% |
| $ 8,000 - $ 9,999 | 16,059 | 10,604 | 66.0% | 10 | 0.1% | 5,445 | 33.9% |
| $ 10,000 - $ 11,999 | 15,554 | 10,861 | 69.8% | 10 | 0.1% | 4,683 | 30.1% |
| $ 12,000 - $ 13,999 | 15,273 | 11,127 | 72.9% | 9 | 0.1% | 4,137 | 27.1% |
| $ 14,000 - $ 15,999 | 14,706 | 11,171 | 76.0% | 23 | 0.2% | 3,512 | 23.9% |
| $ 16,000 - $ 17,999 | 14,483 | 11,383 | 78.6% | 29 | 0.2% | 3,071 | 21.2% |
| $ 18,000 - $ 19,999 | 14,083 | 11,202 | 79.5% | 33 | 0.2% | 2,848 | 20.2% |
| $ 20,000 - $ 24,999 | 32,019 | 19,303 | 60.3% | 1,403 | 4.4% | 11,313 | 35.3% |
| $ 25,000 - $ 29,999 | 27,247 | 11,146 | 40.9% | 8,082 | 29.7% | 8,019 | 29.4% |
| $ 30,000 - $ 34,999 | 23,197 | 7,697 | 33.2% | 8,118 | 35.0% | 7,382 | 31.8% |
| $ 35,000 - $ 39,999 | 20,269 | 6,850 | 33.8% | 6,428 | 31.7% | 6,991 | 34.5% |
| $ 40,000 - $ 44,999 | 17,862 | 7,003 | 39.2% | 5,148 | 28.8% | 5,711 | 32.0% |
| $ 45,000 - $ 49,999 | 16,143 | 6,562 | 40.6% | 4,792 | 29.7% | 4,789 | 29.7% |
| $ 50,000 - $ 54,999 | 14,721 | 6,212 | 42.2% | 4,237 | 28.8% | 4,272 | 29.0% |
| $ 55,000 - $ 59,999 | 13,736 | 5,800 | 42.2% | 4,098 | 29.8% | 3,838 | 27.9% |
| $ 60,000 - $ 64,999 | 12,340 | 5,205 | 42.2% | 3,650 | 29.6% | 3,485 | 28.2% |
| $ 65,000 - $ 69,999 | 11,314 | 4,758 | 42.1% | 3,498 | 30.9% | 3,058 | 27.0% |
| $ 70,000 - $ 74,999 | 10,303 | 4,258 | 41.3% | 3,342 | 32.4% | 2,703 | 26.2% |
| $ 75,000 - $ 79,999 | 9,177 | 3,840 | 41.8% | 2,901 | 31.6% | 2,436 | 26.5% |
| $ 80,000 - $ 89,999 | 15,578 | 6,767 | 43.4% | 4,793 | 30.8% | 4,018 | 25.8% |
| $ 90,000 - $ 99,999 | 11,488 | 5,379 | 46.8% | 3,371 | 29.3% | 2,738 | 23.8% |
| $100,000 - $109,999 | 8,651 | 4,072 | 47.1% | 2,658 | 30.7% | 1,921 | 22.2% |
| $110,000 - $119,999 | 6,170 | 3,101 | 50.3% | 1,871 | 30.3% | 1,198 | 19.4% |
| $120,000 - $129,999 | 4,510 | 2,293 | 50.8% | 1,396 | 31.0% | 821 | 18.2% |
| $130,000 - $139,999 | 3,210 | 1,701 | 53.0% | 955 | 29.8% | 554 | 17.3% |
| $140,000 - $149,999 | 2,410 | 1,363 | 56.6% | 684 | 28.4% | 363 | 15.1% |
| $150,000 - $174,999 | 4,207 | 2,530 | 60.1% | 1,088 | 25.9% | 589 | 14.0% |
| $175,000 - $199,999 | 2,555 | 1,669 | 65.3% | 605 | 23.7% | 281 | 11.0% |
| $200,000 - $299,999 | 4,531 | 3,125 | 69.0% | 1,032 | 22.8% | 374 | 8.3% |
| $300,000 - $399,999 | 1,659 | 1,224 | 73.8% | 320 | 19.3% | 115 | 6.9% |
| $400,000 - $499,999 | 843 | 613 | 72.7% | 170 | 20.2% | 60 | 7.1% |
| $500,000 + | 1,829 | 1,422 | 77.7% | 310 | 16.9% | 97 | 5.3% |
| Totals | 431,875 | 217,452 | 50.4% | 75,065 | 17.4% | 139,358 | 32.3% |

Figure 4 shows the percent of households in each group with a decrease of more than 2% and the percent with an increase of more than 2%.




In the lowest two income groups, the majority of households had less than a 2% change from SB 407. In the groups with income between $4,000 and $25,000, over 60% of households had a tax reduction of at least 2%. In all be the highest of these groups, less than 1% of households had a tax increase of at least 2%, while in the highest of these groups about 4% had a 2% increase.

The groups with income between $25,000 and $150,000 all had about 30% of households with at least a 2% tax increase. Above $150,000 of income, the percent of households with a 2% increase steadily drops, to about 17% for the highest income group.

The percent of households with at least a 2% tax reduction is lowest, about 33%, for households with income between $30,000 and $40,000. For households with income between $40,000 and about $80,000, the percentage hovers around 40%. Above $80,000 of income, the percent with at least a 2% tax reduction rises steadily with income, to about 78% for the highest income group.

The percent of taxpayers with less than a 2% change generally decreases with income, from 96.4% for the lowest income group to 5.3% for the highest.

**Net Revenue Impact**

SB 407 was passed in the spring of 2003. It immediately imposed new taxes on lodging and rental cars and increased the taxes on cigarettes and other tobacco products. It did not change the income tax until 2005. The fiscal note prepared during the 2003 session indicates that SB 407 was expected to increase state revenue in FY 2003 through FY 2005, be approximately revenue neutral in FY 2006, and then to reduce state revenue in later years. The reduction was expected to be $17.0 million in FY 2008 and to grow over time.

The fiscal note estimated that income tax revenue would be $38.9 million lower in FY 2006 because of SB 407 and that the reduction would grow over time. Actual income tax revenue was $768.9 million for FY 2006 and $815.1 million for FY 2009. This is a 6.0% increase. Assuming that the reduction from SB 407 would have grown at the same rate as revenue, it would have been $41.2 million for FY 2009.

The income tax revenue estimating model was used to estimate revenue under the pre-SB 407 law and under current law for FY 2006 through FY 2013. For FY 2006 through FY 2008, the model was used to recalculate taxes for returns from tax years 2005 through 2008 as if SB 407 had not been in effect. For FY 2009 through FY 2013, the model was used to forecast future tax liability, with and without SB 407, using the growth assumptions in the 2009 legislative revenue estimate. Figure 5 shows full-year residents' tax liability for tax years 2005 through 2013, with and without SB 407. Table 8 shows the estimated difference in revenue due to SB 407 in each of those years.

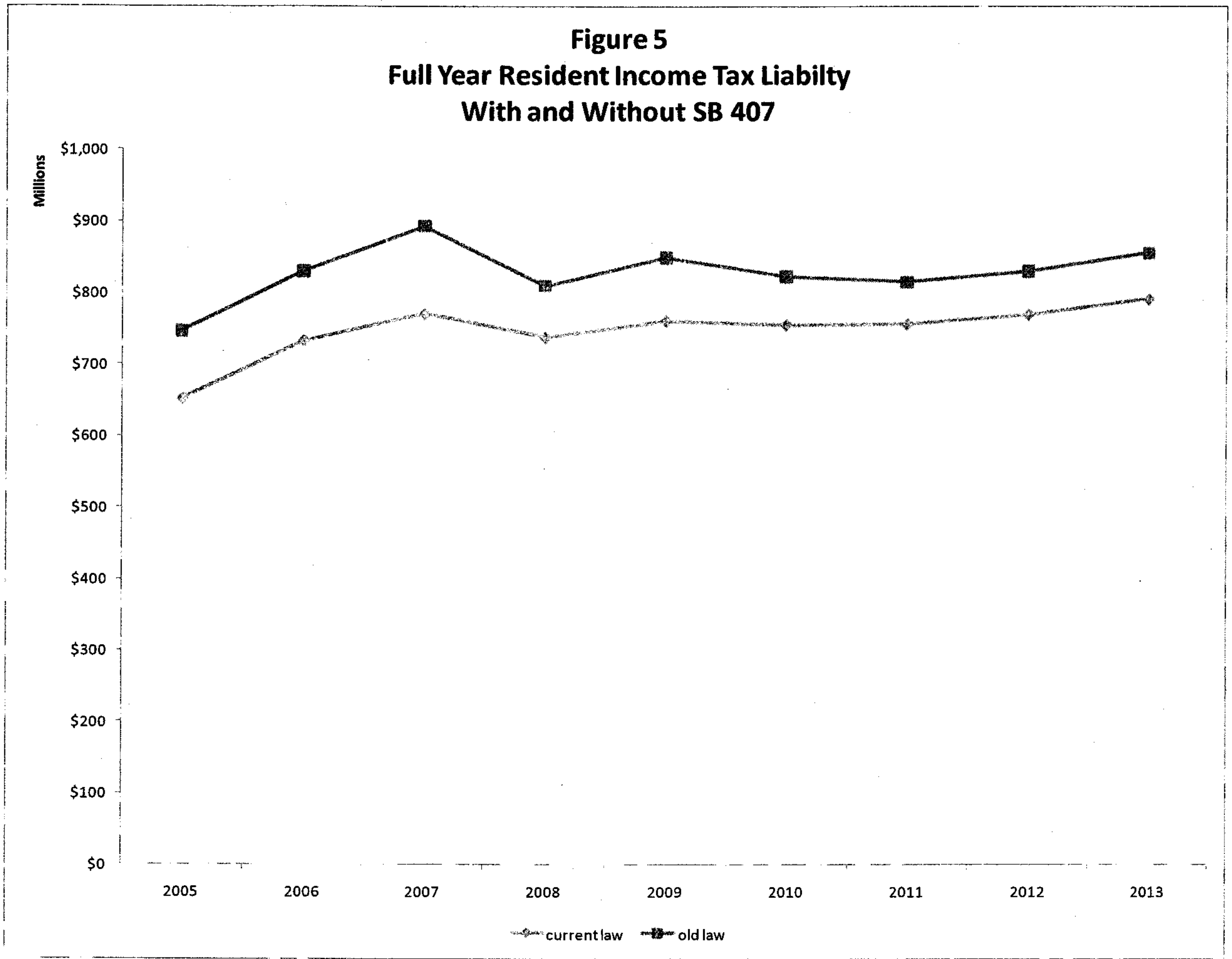



**Table 8**
**Estimated Income Tax Revenue Reductions from SB 407**
**FY 2009 to FY 2013**

| Fiscal Year | $ million |
|---|---|
| FY 2006 | -$101.539 |
| FY 2007 | -$116.920 |
| FY 2008 | -$104.210 |
| FY 2009 | -$86.310 |
| FY 2010 | -$84.376 |
| FY 2011 | -$69.364 |
| FY 2012 | -$66.790 |
| FY 2013 | -$70.981 |

For FY 2006, the income tax revenue reduction is 2.6 times as large as estimated in the fiscal note. The estimated reduction increases in FY 2007, decreases each year from FY 2008 through FY 2012, and then increases again in FY 2013.

Table 9 compares the estimated income tax reduction for FY 2009 to actual revenue from the new taxes and tax increases in SB 407.

**Table 9**
**FY 2009 Revenue Impact of SB 407**
**($ million)**

| | |
|---|---|
| Income Tax | -$86.3 |
| Accomodations Sales Tax | $12.5 |
| Rental Car Sales Tax | $2.9 |
| Cigarette Tax ($0.52 of $1.70) | $24.4 |
| Tobacco Tax (12.5% of 50%) | $2.6 |
| Net Impact | -$43.9 |

The net revenue loss for FY 2009 is more than two-and-half times the FY 2007 net revenue loss estimated in the fiscal note. This difference is primarily from actual revenue being different from the 2003 predictions, rather than from growth between FY 2007 and FY 2009. Revenue from the accommodations sales tax and the tobacco tax increase are significantly higher than the FY 2005 estimates from the fiscal note. Revenue from the rental car sales tax is slightly higher, and revenue from the cigarette tax is lower. Overall, revenue from the new revenue sources in SB 407 is slightly higher than projected, but the loss in income tax revenue is much higher than projected.

A number of factors contributed to the fact that revenue reductions are larger than was predicted in 2003[1]. In 2005, Montana adjusted gross income was 16% higher than forecast. A larger tax base led to larger revenue reductions from rate cuts. In 2005, capital gains income was approximately twice what had been predicted in 2003. This made the revenue reduction from the capital gains credit much larger than predicted. Income growth from 2003 to 2005 went disproportionately to high-income taxpayers, who received larger-than-average percentage tax reductions from SB 407.

Between 2003 and 2005, Congress enacted several changes that reduced federal income taxes in 2005, particularly for higher income taxpayers. Under the old law, this would have resulted in a windfall for the state, as taxpayers with smaller deductions for federal taxes paid higher state taxes. With SB407, these federal tax changes did not affect state taxes for higher-income taxpayers whose deductions for federal taxes are capped. This made the state windfall from reduced federal taxes smaller than it would have been under old law.

One of the reasons that the revenue impact of SB 407 was smaller for 2008 than for 2005 was the fact that there was a jump in federal taxes paid in 2008. This appears to have been primarily from taxpayers who had under-paid during 2007 making payments

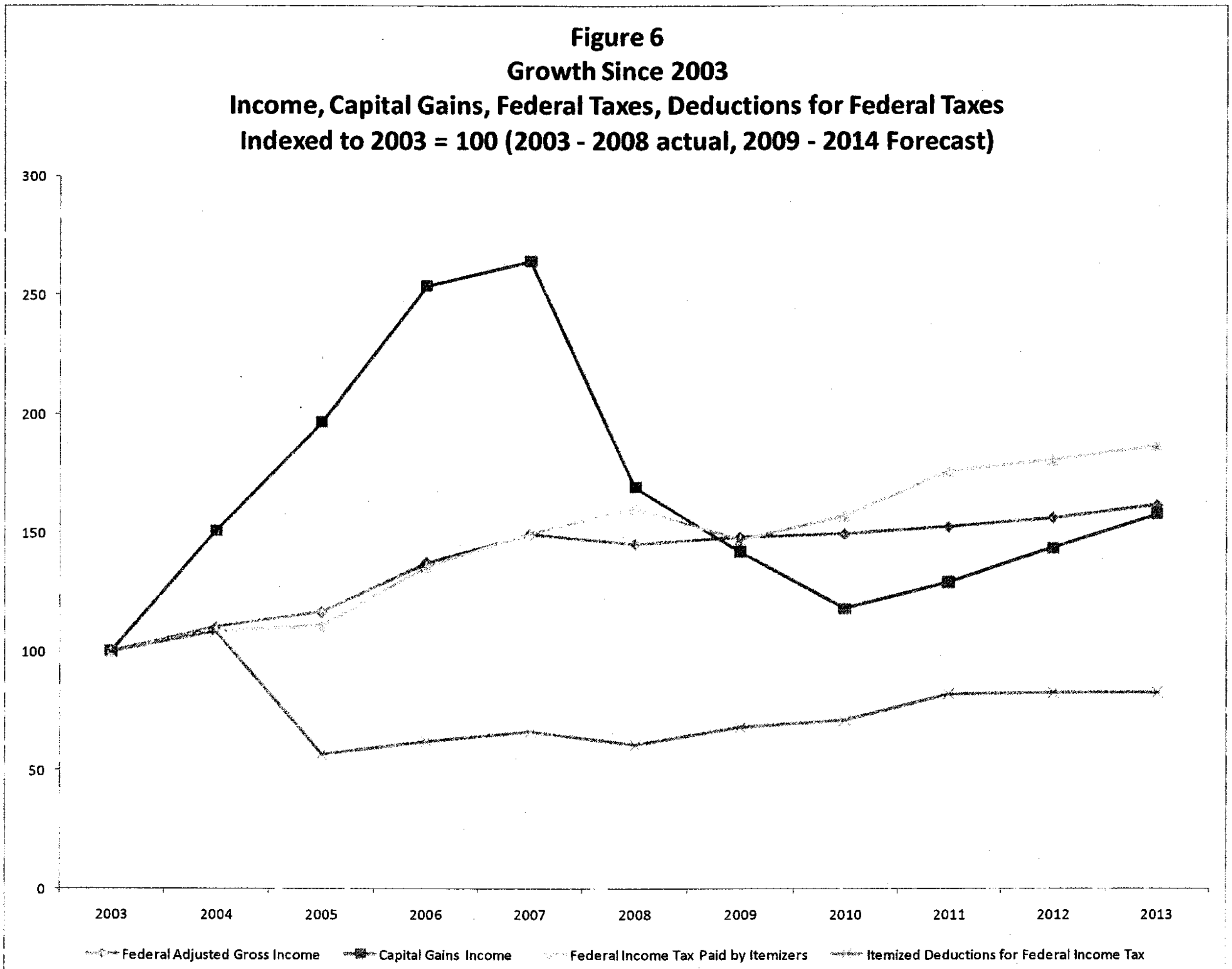
[1] For a full analysis, see "Explaining the Difference Between the Forecast and Actual Impacts of Senate Bill 407," Montana Department of Revenue, January 2007.

with their 2007 returns in the spring of 2008 and increasing their estimated payments for 2008. Another reason for the smaller impact in 2008 is that capital gains income was lower in 2008 than in 2005, and therefore the impact of the capital gains credit increasing from 1% to 2% was lower than it would have been.

Figure 6 shows actual and projected growth since 2003 in some of the more important factors affecting the fiscal impact of SB 407. It shows federal adjusted gross income, capital gains income, federal income tax paid by Montana taxpayers who itemized deductions, and itemized deductions for federal taxes, all as indexes with their 2003 values as the base. Thus, the index value for each series tells the ratio of the value in a later year to the value in 2003. For example, the index value for federal taxes in 2008 is 150, which means that federal taxes in 2008 were 150% of what they had been in 2003.

Income grew steadily and rapidly between 2003 and 2007, but growth is predicted to be much slower through 2013. The capital gains component of income grew dramatically from 2003 through 2007, but then dropped in 2008. It is forecast to drop again in 2009 and 2010 and then to grow more slowly through 2013.

Federal taxes are not growing in lock-step with income. The slower growth in 2005 reflects changes in federal law between 2003 and 2005 which included temporary tax reductions and acceleration of several tax reductions that had been passed in 2001 but were not scheduled to go into effect until later years. The divergence in 2008 reflects the extra payments made that year by high-income taxpayers who had underpaid in 2007. The gap between the indices for federal taxes and income beginning in 2011 is due to higher taxes when temporary tax reductions passed in 2001 through 2003 expire.




Total deductions for federal taxes do not follow federal taxes very closely. The large drop in 2005 is from the first year of the cap on the deduction. In 2008, when federal taxes increased, deductions for federal taxes actually fell, because the additional federal tax payments made in 2008 were mostly made by taxpayers whose deductions for federal taxes were capped. Deductions for federal taxes are forecast to increase much less than federal taxes in 2011 because much of the expected increase in federal taxes will go to taxpayers whose deduction is capped.

The cap on the deduction for federal taxes appears to have somewhat insulated state revenue from changes in federal taxes. The state missed out on a revenue windfall from federal tax reductions in 2005 but will also miss a large revenue hit from federal tax increases in 2011.

The falling income tax revenue reduction appears to be due largely to falling capital gains income in 2008 through 2010, high federal income tax payments in 2008, and federal income tax increases in 2011.